Willem F Duisenberg: Hearing before the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Dr Willem F Duisenberg, President of the European Central Bank, Brussels, 23 November 2000.

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As usual, I shall report on recent monetary policy decisions taken by the ECB and on the reasoning underlying these decisions. In addition, I should like to inform you about the decision taken by the Governing Council of the ECB last week to publish staff economic projections for the euro area. Finally, I should like to say a few words about the progress report, which has been published by the ECB as part of its initiative to improve cross-border retail payment services in the euro area.

1. Economic and monetary developments

After the last hearing before this Committee on 12 September, the Governing Council of the ECB decided to increase the ECB's main interest rates by 25 basis points on 5 October 2000. The decision was taken to ensure that upward pressures on consumer prices would not translate into more permanent tendencies. It was based on evidence from both pillars of the monetary policy strategy of the ECB, notably continued money growth above the reference value and upward pressure on consumer prices owing to oil price and exchange rate effects in an environment of robust economic growth.

Let me comment in more detail on the Governing Council's assessment of the current economic situation. In the period from July to September 2000, the three-month average of M3 growth stood at 5.4%, above the reference value of 4½%. However, some indicators suggest that over recent months a moderation in monetary growth has been occurring.

Let me now turn, within the second pillar, to the prospects for economic growth in the euro area, as these represent a key factor affecting the outlook for price stability in the medium term. The latest estimate by Eurostat for the second quarter of 2000 indicated a real increase in GDP of 0.8%. The pace of new job creation has remained high and the unemployment rate currently stands at 9.0%, a level not seen since mid-1992. Some monthly indicators suggest that some moderation in real GDP growth might have occurred in the second half of this year, mainly as a result of the negative impact of the recent increases in oil prices on domestic income. However, by contrast with previous periods of strong oil price rises, the euro area economy is now less dependent on oil. This should help to prevent any sustained negative effect on confidence. There are therefore good reasons to remain confident with regard to growth prospects.

On the external side, euro area export growth should benefit further from the expansion of the global economy. Considering these factors together, the growth dynamic in the euro area can be expected to be maintained in the coming years. Forecasts by international and private organisations currently project euro area real GDP growth in the coming one to two years to be somewhat lower than this year's more than 3%, but to remain at around 3%.

The exchange rate of the euro has remained a cause for concern. The depreciation of the euro during 1999 and 2000 has added to upward pressures on consumer prices in the euro area. The exchange rate of the euro has now remained out of line with economic fundamentals for a prolonged period of time. The G7 expressed concern about the global repercussions of the current level of the euro exchange rate. In order to support the euro, concerted interventions by all G7 members, on the initiative of the ECB, took place on 22 September, and the Eurosystem intervened several times in November.

Recent Harmonised Index of Consumer Prices (HICP) inflation rates have been higher than could have been expected only a few months ago. Current inflation reflects the unexpected sharp rise in oil prices in recent months. Notwithstanding a possible decline in oil prices, annual HICP inflation rates are likely to remain above 2% for some time to come.

It needs to be recognised that current upward pressures on consumer prices can be alleviated most smoothly if economic agents see them for what they are, namely one-off or temporary price increases resulting from external factors. In this respect, when forming their expectations, economic agents should count on the commitment of the Governing Council of the ECB to maintaining price stability, defined as HICP inflation below 2%, in the medium term. Monetary policy will not accommodate inflationary tendencies in the euro area.

It will be critical to ensure that the temporary upward pressure on HICP inflation is not followed by more lasting upward pressure from domestic factors. The interest rate measures taken by the ECB over the past few months were aimed at containing the emergence of inflation expectations and convincing the social partners, as well as the public at large, that price stability in the euro area will be maintained. By ensuring that wages continue to grow at a moderate pace in 2001 and, may I add, beyond next year, wage-setters would facilitate the ECB's task of maintaining price stability. They would at the same time make an important contribution to maintaining the current strong employment growth in the euro area.

The maintenance of robust non-inflationary growth is a challenge faced in many policy areas, as well as by the social partners. Many euro area countries have embarked on a path of structural reform, which they now need to adhere to strictly. Increasing the flexibility of labour markets and deregulating product markets will enhance the growth potential of the euro area by allowing for a better exploitation of the opportunities which are offered, for instance, by the single currency and the new information and communications technologies. Reforms are all the more important to help the economy adapt smoothly to external shocks such as those currently observed.

In many countries, governments also need to press ahead with fiscal consolidation and fiscal reform. Budget deficits in the euro area as a whole are expected to improve this year, but this will mainly be the result of strong economic growth and one-off revenues from the sale of UMTS licences. Abstracting from these factors, there has been little further progress in the consolidation of public finances on average. Moreover, current budget plans for 2001 imply that the average fiscal stance will be slightly more expansionary next year. For the first time since 1993, the primary balance ratio as a percentage of GDP for the euro area is expected to deteriorate in 2001. This somewhat more expansionary stance demonstrates that the reform strategies have, in some cases, been unbalanced. Many countries have enacted reductions in personal and corporate income taxation and social security contributions, but have not set ambitious expenditure ceilings. While the tax reforms currently being implemented or planned in a number of euro area countries are a welcome stimulus to the supply side, they need to be accompanied by restraint in government spending.

The longer-term sustainability of budget positions also needs to be ensured in several countries with regard to the consequences of planned fiscal reforms, such as those of pension systems, and the reduction of taxes. The policy adjustments necessary to create the financial leeway for these reforms should be prepared now. A loosening of the fiscal stance stemming from an unbalanced reform strategy not only jeopardises fiscal consolidation but, from a longer-term perspective, also reduces the potential for positive supply effects of fiscal reform on economic growth.

2. Publication of staff macroeconomic projections by the ECB

I shall now turn to the envisaged publication of staff macroeconomic projections by the ECB.

I have previously stated in my remarks to the European Parliament that the ECB could commence the publication of macroeconomic projections during the course of this year. I am now happy to inform you that our preparations have been concluded. As was announced on 16 November, the Governing Council has decided to commence publication of its staff macroeconomic projections in the December issue of the ECB Monthly Bulletin. This decision reflects the Governing Council's conviction - as reflected in practice - that the information and analysis underlying its monetary policy decisions should be shared with the public to the greatest extent possible, subject, of course, to the necessary preparation. Provision of this information will further enhance transparency and lead to a better understanding of the single monetary policy.

The ECB has decided that the time has come to publish its staff macroeconomic projections, which are already used as an input into the assessment of the outlook for price stability. These are prepared twice a year by Eurosystem staff as one of a number of inputs into the deliberations of the Governing Council. The projections will be published in the June and December issues of the ECB Monthly Bulletin, commencing in December 2000. Projections will be published for the growth rate of real GDP and its components and for HICP inflation. They will have a two-year horizon, so that the projections for both 2001 and 2002 will be published in December this year. In order to accurately reflect the degree of uncertainty attached to such exercises, the projections will be published in the form of ranges, based upon the average absolute errors made in previous national central bank and Eurosystem projections. The projections will be accompanied by a text describing their main features.

I should emphasise that we use the word "projection" in order to signal that the published projections are the results of a scenario based on a set of underlying technical assumptions, including the assumption of unchanged monetary policy. This is the way forecasts are produced in many central banks in order to best inform monetary policy decision-makers. As the Eurosystem's staff economic projections are the products of a technical exercise, which assumes, inter alia, that short-term interest rates and the exchange rate will not change over the forecast horizon, it should be clear that the staff projection will not, in general, be the best predictor of future outcomes, in particular for somewhat longer horizons. Rather, it represents a scenario which is likely to be falsified in practice, since monetary policy will always act to address any threats to price stability.

On making this announcement, it is crucial that I explain again the role which staff macroeconomic projections play in the ECB's monetary policy strategy.

The ECB's primary objective is the maintenance of price stability in the euro area. Given the lags in the transmission of monetary policy to the price level, monetary policy must be forward-looking. Therefore, all analysis undertaken at the ECB is focused on the risks to future price stability.

The analysis underlying monetary policy decisions is organised within two frameworks, which we refer to as the two pillars. The Governing Council's forward-looking assessment of the economic situation and the outlook for price stability is based on both a prominent role for money, denoted as the first pillar, and a broadly based assessment of other economic and financial indicators, labelled the second pillar. The projections that will be published by the ECB as from December are, as with any conventional macroeconomic forecast or projection, derived from analytical frameworks in which money plays only a limited role, if any. Hence such projections, which mostly reflect developments in variables other than money, naturally form part of the second pillar of the ECB's strategy.

The projections help to underpin the forward-looking orientation of monetary policy. They summarise and synthesise a large quantity of information that might otherwise be too unwieldy to form a sensible basis for policy discussions. They also provide a platform for the integration of economic analysis under the second pillar in a coherent and internally consistent way, which seeks to reflect past experience and fundamental economic relationships.

Twice a year, the Monetary Policy Committee of the Eurosystem undertakes, with the help of a Working Group on Forecasting, a forecasting exercise which brings together staff from both the ECB and national central banks. The macroeconomic projections produced by these exercises combine analysis based on a variety of econometric models with expert assessments made by staff. The Eurosystem's staff projections are therefore not the result of the mechanical application of a single econometric model. On the contrary, they combine a variety of different analyses, all of which rely on the staff's technical expertise.

Although they play a useful and important role, the projections are not a panacea. First, they are always based on specific assumptions - such as those concerning oil prices or exchange rates - with which it is possible to disagree or which can change rapidly, so that the projections become outdated. Second, the final projection depends to a great extent on the underlying conceptual framework or techniques employed in its production. Third, by their very nature, economic frameworks can only provide a summary description of the economy and thus do not incorporate all relevant information. In particular, some information is not easily integrated into the framework used to produce the projections or may change after they are finalised. Fourth, expert views are inevitably incorporated into projections and there can be good reasons at any moment of decision-making to deviate from the particular views or approaches on which they are based.

The two-pillar approach chosen by the Eurosystem - including a prominent role for money as the first pillar - is, to some extent, a reflection of these general limitations of forecasts and projections.

I should stress that, because of these limitations, the second pillar of the ECB's strategy also includes other forms of analysis in addition to macroeconomic projections. First, the ECB's projections are cross-checked and compared with forecasts produced by others, such as international organisations and private sector entities. Second, the forward-looking information and expectations embodied in financial prices and yields is thoroughly analysed and evaluated. This information can also be compared with the staff projections. Finally, any information that is not contained in the staff projections for practical or timing reasons - such as the latest available outturns of certain data series - must also be incorporated into the overall assessment. Developments in individual indicators are also closely followed outside the framework of the forecasting exercise.

It follows from this discussion that the Governing Council does not use its staff projections as the main tool for organising and communicating its assessment. Rather, the Governing Council evaluates them alongside - and compares them with - many other pieces of information and forms of analysis organised in the two-pillar framework. In the context of the ECB's strategy, macroeconomic forecasts and projections therefore play an important - albeit limited - role.

Two important points follow from the role of projections in the ECB's strategy and the procedures used to produce projections within the Eurosystem.

First, the projections are produced by staff experts and do not embody the policy judgement of the Governing Council. They therefore represent one input into the policy-making process and not the outcome of the Governing Council's deliberations. The Governing Council must exercise a policy judgement in evaluating the projections it receives, alongside all other analyses, when drawing implications for policy decisions.

Second, since policy decisions are based on a broad range of analyses conducted under the two pillars of the ECB's monetary policy strategy - of which the Eurosystem's projections constitute only a part - one should not expect policy decisions to respond mechanically to developments in the published macroeconomic projections. In this respect, the projections published by the ECB and their role differ considerably from the forecasts published by some other central banks.

One question which has been raised since the announcement is why the Governing Council does not assume full responsibility for the projections to be published by the ECB, whilst of course accepting full responsibility for the staff that produces them. Let me answer this question by recalling the Governing Council's ultimate responsibility, namely to maintain price stability in the euro area. Within the framework of the Treaty establishing the European Community (EC Treaty), the Governing Council shall be held accountable for the maintenance of price stability in accordance with its published definition. The Governing Council is neither responsible for the content of these projections, nor should its performance be judged against them. While macroeconomic projections are a useful instrument for undertaking the forward-looking assessment on which monetary policy decisions are based, the limitations I have outlined imply that such projections cannot be the only tool used by the Governing Council. The Governing Council should no more assume responsibility for the staff macroeconomic projections than it does for the content of other analyses that constitute inputs into its policy decisions, such as the monetary analysis under the first pillar or the evaluation of developments in individual indicator variables or financial prices and yields. Assuming responsibility for one input into its decisions would detract from the Governing Council's true responsibilities, first for monetary policy decisions and ultimately for the maintenance of price stability.

Given the Governing Council's overriding commitment to the maintenance of price stability, the only forecast for which it could take responsibility would be one that was consistent with price stability.

Such a forecast - which, by its nature, would not change over time - would not, in itself, be very informative about the Governing Council's assessment of the prevailing economic situation. The Governing Council's own guidepost for the future was published at the outset in the form of its quantitative definition of the ECB's primary objective. This definition serves a different purpose, namely to anchor inflation expectations.

Against this background, the published macroeconomic projections should not, under any circumstances, be seen as calling into question the commitment of the Governing Council to maintaining price stability over the medium term. The public, wage and price-setters, and all firms and households should continue to rely on the ECB's quantitative definition of price stability as the "best prediction" of medium-term price developments, since the Governing Council is committed to changing monetary policy whenever this is necessary to maintain price stability.

The publication of staff macroeconomic projections thus informs the public about an important input into the Governing Council's decision process, which has already been used in the past. The publication of projections has to be considered in the context of the ECB's monetary policy strategy. Publication thus changes neither the ECB's monetary policy strategy nor the role of these projections within it.

I am convinced that publication of these staff projections can help to improve the ECB's presentation and explanation of monetary policy decisions. However, if this is to be the case, the public - and the European Parliament and your Committee - must recognise the limitations of forecasts and projections that I have just described, and the implications these limitations have for the role of staff projections in the ECB's strategy.

3. Cross-border retail payment services in the euro area

You may recall that in September 1999 the ECB published a report presenting the views of the Eurosystem on how to improve cross-border retail payment services and defining the objectives that the industry is expected to achieve by 1 January 2002. In September this year, the ECB published a progress report. This report concludes that, although most objectives have not yet been fulfilled, substantial progress has been made in preparing the ground for a more efficient handling of cross-border retail payments. Allow me to give you some examples:

i. The banking sector has agreed on straight-through processing standards, which will allow the automated execution of cross-border payments;

ii. The Euro Banking Association has developed a payment system specifically designed for cross-border low-value payments, which commenced operations on 20 November 2000;

iii. As from 2002, cross-border payments below EUR 12,500 will no longer need to be reported for balance of payments purposes and hence statistical reporting will no longer constitute a justification for high customer fees.

Insufficient progress has been made in the field of customer prices. In too many cases, the payee has been charged with some costs even though the payer had agreed to bear all costs. Two initiatives currently being developed by the European Credit Sector Associations are intended to address this situation. First, a multilateral interbank exchange fee is being developed, which, provided that the fee is low, could be acceptable and could indeed contribute to solving the problem of "double-charging". Second, and more importantly, a "basic" service will be defined which, for payment orders submitted in the correct format, should provide a guaranteed service level with attractive conditions in terms of price and execution time. The Eurosystem welcomes the idea of a basic service offer, but the progress report went one step further by inviting banks to set up a "standard" cross-border payment service with a common name, to be provided by most banks in the euro area. Such a standard service would contribute even more to greater price transparency and, consequently, enhanced competition.

The progress report also recognises that the achievement of the objectives depends not only on banks but also on companies and customers, who should include adequate information in invoices and payment orders so as to facilitate straight-through processing. The Eurosystem is therefore urging the banking industry to launch an information campaign and expects specific proposals by the end of 2000. The organisation of such an information campaign would be greatly facilitated if a standard service with a common name existed.

The Eurosystem will continue to closely monitor the progress made by the banking industry with regard to the outstanding issues, as well as developments in customer prices, in order to ensure that the preparations currently under way do ultimately translate into adequate services for European citizens. All options, including the operational involvement of the Eurosystem, will be retained, in case the situation has not improved significantly by 2002.